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MILITARY RETIREMENT

Proposed Changes Warrant
Careful Analysis

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Mr. Chairman and Members of the Subcommittee:

I am here today to discuss military retirement. Concerned about its ability to retain personnel, the Department of Defense (DOD) has proposed pay and retirement changes in its fiscal year 2000 budget. The pay proposal includes a 4.4 percent, across-the-board raise and pay table reform that will target increases to noncommissioned officers and mid-grade commissioned officers. The retirement change proposed by DOD is essentially a partial repeal of the 1986 Military Retirement Reform Act, which is commonly called "Redux."

After providing background on the differences among the various military retirement systems and how those differences came into being, I will address (1) changes being proposed by DOD; (2) areas where we believe more information is needed; and (3) the opportunity to take a long-term, strategic view of the military compensation system. But first, I will summarize our observations regarding DOD's proposed changes to the military retirement system.

Results in Brief

Overall, we see no clear indication that the proposed change to the retirement system, which would cost an estimated \$13 billion in increased costs and unfunded liabilities, will address the retention issue.

While the recently reported downturn in retention rates is of concern, the nature of the retention problem is not clear. Is the problem widespread or is it concentrated in certain military occupations or year groups? Is it a transitory problem attributable to such factors as reduced accessions during the drawdown and the strong economy, or is it the beginning of a long-term problem that will affect the military for the foreseeable future? Understanding the nature of the retention problem is critical in choosing solutions—pockets of problems are best treated with targeted rather than across-the-board solutions, and transitory problems are best treated with actions that can be reversed or eliminated once the problem has receded.

According to DOD, Redux has become a symbol of eroding benefits to military members. Although surveys of military personnel show an increasing level of dissatisfaction with the retirement system, it is not clear what that really means. Some of the surveys do not differentiate between retirement pay and other retirement benefits. Also, many military personnel appear to lack knowledge about their retirement system. For

example, a 1998 Navy survey showed that over half the respondents did not know which retirement system they were under.

The link between retirement pay and retention is unclear. The decision to stay in or leave the military is a complex, highly individual decision. Many factors (such as the availability of civilian jobs, family considerations, and satisfaction with military life) can influence a servicemember's decision. The influence of retirement in this decision has not been definitively determined. According to an analysis done by the Congressional Budget Office, retention rates under Redux have not been markedly different than rates under the prior system. Even if the retirement system is found to be related to retention, it may not be the most cost-effective tool for addressing any existing retention problems. For example, when given a choice, military members have tended to prefer up-front compensation to deferred compensation.

In addition, DOD's proposal does not address other military retirement issues and their impact on the structure of the force. For example, DOD's proposal does not address a key purpose of the Redux system—to encourage personnel to remain on active duty after reaching 20 years of service. Also, since the first potential Redux retirees are still more than 7 years away from retirement eligibility, DOD may be missing the opportunity for the kind of comprehensive change to its compensation system suggested by the Eighth Quadrennial Review of Military Compensation. The June 1997 Report of the Quadrennial Review called for DOD to take a broad approach to align its policies with its strategy—rather than take a piecemeal or “one-size-fits-all” approach.

Current Retirement Systems for Military Personnel

Military members are presently covered by three separate retirement systems, depending on when they joined the military. All three systems require no contribution from the servicemember and allow retirement after 20 years of service. Servicemembers have no vesting before 20 years. Military members pay social security taxes and are eligible for social security benefits, as well.

Depending on when servicemembers joined, the amount of their military pension is calculated differently. Reforms in 1980 altered the pension calculations, changing the computation base from 50 percent of the final monthly basic pay to 50 percent of an average of the highest 3 years of basic pay (often called the “high-3” system). Under these two systems, retirees are eligible for 75 percent after 30 years.

Major reforms followed in 1986. At that time, there were concerns about the cost of the military retirement system, given the large standing military force and the budget deficits at the time. Further, some believed that the retirement system was overly generous. These concerns ultimately led to the passage of the Military Retirement Reform Act. Redux reduced the retired pay calculation in such a way that retirees with 20 years of service would receive 40 percent of their high-3 basic pay—rather than the 50 percent received under the previous two systems. Under all three systems, however, servicemembers earn 75 percent after 30 years because Redux increased the amount earned each year toward retirement after 20 years in such a way that retirees receive 3.5 percent for each additional year of service up to 30.

Another feature of Redux is a reduced cost of living adjustment (COLA). High-3 retirees receive an annual adjustment equal to the consumer price index (CPI). However, Redux retirees' annual adjustment is 1 percentage point less than the CPI.

When retirees reach age 62, retirement pay is recalculated at 2.5 percent per year of service at retirement, and COLA is recalculated to restore the purchasing power lost due to the annual COLA reductions. Thus, at 62, Redux retirees with 20 years of service would receive 50 percent, rather than 40 percent, of their high-3 basic pay and all COLA decrements would be made up. After age 62, retirees' pay remains at 50 percent of their average high-3 basic pay, but the 1-percent reduction in COLA begins again. Table 1 describes the features of all three retirement systems.

Table 1: Current Retirement Systems for Military Personnel

	Final pay	High-3	Redux
Applies to servicemembers joining:	Before September 8, 1980	Between September 8, 1980, and July 31, 1986	On or after August 1, 1986
Basis of computation:	Final basic pay	Average basic pay for highest 3 years	Average basic pay for highest 3 years
Multiplier	2.5 percent per year of service	2.5 percent per year of service	2 percent per year at 20 years; 3.5 percent per year thereafter up to 30 years of service (2.5 percent restored at age 62) ^a
Cost-of-living adjustments	CPI	CPI	CPI minus 1 percent (one-time catch-up at age 62) ^b

^aAt age 62, the retiree's pay will be recalculated based upon the number of years of service multiplied by 2.5 percent up to a maximum of 75 percent.

^bA one-time recomputation of the retiree's annuity to make up for lost purchasing power caused by the holding of COLAs to the inflation rate minus 1 percent. #R-11 COLAs for Military Retirees: Summary of Congressional and Executive Branch Action, 1982-1998.pop

Source: DOD.

None of the retirement changes were retroactive. Redux applied only to servicemembers who joined on or after its effective date of August 1, 1986. This change was made prospectively so that it would not affect servicemembers who entered the service under the previous systems.

Redux was adopted for two main reasons. The first was cost. Congress wanted to reduce the overall cost of the military retirement system but still provide fair and equitable retirement benefits. Redux is a less costly system than its predecessors. According to an estimate prepared in 1998, the DOD actuary estimated that the military would have needed to put aside an additional \$7.5 billion between 1986 and 1999 had Redux not been passed.

The second reason for Redux was to provide an incentive for personnel to stay past 20 years of service and thus to increase the size of the senior career force. For each year of service beyond 20, Redux provided servicemembers with 3.5 percent toward their retirement pensions. According to the DOD actuary, about 47 percent of retirees leave within 1 year after reaching 20 years of service; by 3 years, almost 70 percent have left. Since the first Redux-covered servicemembers will not reach 20 years of service until 2006, it is unknown whether this incentive will actually

encourage servicemembers to remain in the military. Table 2 compares the percent of base pay that retirees would receive under the high-3 and Redux systems depending upon the years of service they had at the time of retirement.

Table 2: Percentages of Base Pay Used to Calculate Retirement Pay Under the High-3 and Redux Retirement Systems by Years of Service.

Years of service	20	21	22	23	24	25	26	27	28	29	30
High-3	50	52.5	55	57.5	60	62.5	65	67.5	70	72.5	75
Redux	40	43.5	47	50.5	54	57.5	61	64.5	68	71.5	75

Source: GAO.

Figures 1 and 2 compare the projected retirement pay for hypothetical retirees under the high-3 and Redux systems over a 30-year period.¹ Figure 1 shows what an officer at the O-5 pay level would earn after retiring at 42 years of age with 20 years of service. Figure 2 shows what a noncommissioned officer at the E-7 pay level would earn after retiring at 38 years of age with 20 years of service. The figures illustrate the adjustment that would be made under Redux at age 62 to equalize the retirement pay with the high-3 system. After age 62, the figures illustrate the impact of the reduced COLA provision for the Redux retiree.

¹The charts use the "over 20" column of the January 1998 pay tables as the high-3 average. In addition, the charts assume a 3.5-percent annual change in the CPI.

Figure 1: Projected Annual Retirement Pay (42 year old O-5 after 20 years of service)

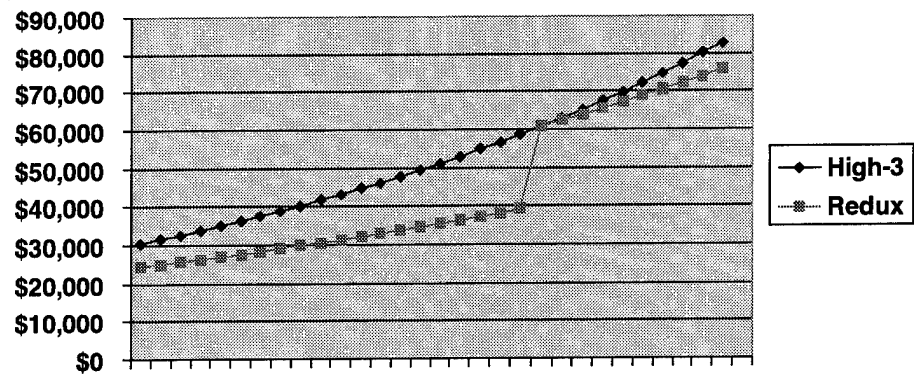
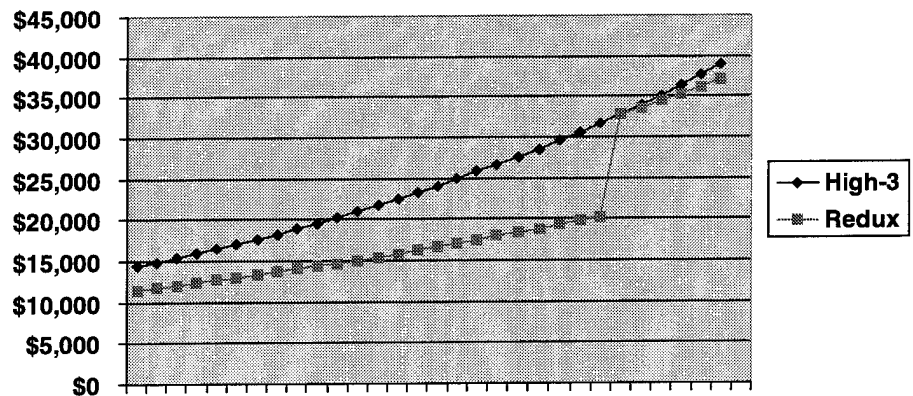


Figure 2: Projected Annual Retirement Pay (38 year old E-7 after 20 years of service)



Without having had to contribute toward retirement, retirees become eligible to receive an income for life at a relatively young age—in their late 30s to early 40s—allowing them to engage in other, full-time employment. Military retirees do not usually completely retire from the workforce; instead, they have a second career. The catch-up provisions in Redux provide for restored benefits at age 62, when military retirees are more likely to actually be fully retired and are eligible for social security benefits.

More than two-thirds of the current military force came in after the effective date of the 1986 Reform Act and would be covered by Redux,

should they retire. This includes large numbers of junior enlisted personnel in the force. At the end of fiscal year 1997, the DOD actuary estimated that about 16 percent of the enlisted personnel who entered the service stay to earn a military retirement. A higher proportion of officers, about 46 percent of those who entered the service over that same period, are likely to stay for 20 years or more.

It is important to note that no one has yet taken a nondisability retirement under Redux. The first Redux retirees will reach retirement eligibility in 2006, 20 years after the effective date of the legislation. The most senior military members covered by Redux—those who entered the military just after the effective date of August 1, 1986—now have approximately 12-½ years of military service. Thus, the first potential Redux retirees are still more than 7 years from retirement.

DOD Proposal to Change Military Retirement

DOD has proposed pay and retirement changes in its fiscal year 2000 budget as a means of addressing declines in retention. The pay portion of the proposal contains two parts: a 4.4-percent, across-the-board pay raise and pay table reform that will provide targeted pay increases to noncommissioned officers and mid-grade commissioned officers. The retirement change proposed by DOD would essentially be a partial repeal of Redux. DOD's proposal would restore the multiplier provision to allow servicemembers to earn 50 percent of their high-3 salary at 20 years of service. DOD proposes to alter the way the COLA is calculated, as well. When the CPI is more than 3 percent, the formula would still be CPI minus 1 percent. However, the proposal provides some low-inflation protection when the CPI drops below 3 percent. If the CPI is between 2 and 3 percent, the cost-of-living adjustment would be 2 percent. If the CPI is below 2 percent, retirees would receive a full cost-of-living adjustment.

DOD estimates that the retirement changes it proposes will cost about \$6 billion over the next 6 fiscal years (2000-2005). This is about 24 percent of the \$24.7 billion total cost of the DOD military pay and retirement proposal.² This \$6 billion represents the additional amount that DOD projects it will need to pay into the retirement trust fund to provide increased benefits. The year-by-year accrual projections are shown in table 3.

²The total estimate does not include the cost of giving DOD civilians a commensurate 4.4-percent pay raise. According to DOD, the cost of the DOD civilian pay raise would be about \$10 billion.

Table 3: DOD Projections of the Additional Accrual Costs to Fund Its Proposed Retirement Changes in the Fiscal Year 2000 President's Budget

Dollars in millions

Fiscal year	Multiplier repeal	COLA reform	Total accrual projection
2000	\$601	\$195	\$796
2001	656	232	888
2002	713	270	983
2003	773	276	1,049
2004	797	285	1,082
2005	862	291	1,153
Total	\$4,402	\$1,549	\$5,951

Source: DOD.

DOD's cost figures do not include an estimated \$7 billion³ increase in the unfunded liability for the military retirement trust fund if Redux were repealed. This liability would increase because DOD has been setting aside money for the less-costly Redux retirement plan since its adoption in 1986. At the end of fiscal year 1997, the total existing unfunded liability in the military retirement trust fund was almost \$500 billion. The trust fund has a large unfunded liability because, prior to 1984, DOD did not set aside funds to pay for retirement liabilities. The \$500 billion is what remains of the unfunded liability identified when DOD switched to accrual accounting practices. The unfunded liability is assigned to the Treasury to pay off over a very long period of time; the DOD actuary estimates that the initial unfunded liability will be fully amortized in 2033.

Personnel Surveys Provide Mixed Results

In support of proposed retirement changes, the military leadership has cited growing dissatisfaction among military members about their retirement benefits. Reports of dissatisfaction have often been anecdotal—arising when military leaders visit the troops. In addition, various DOD and service surveys show that military members have increasingly cited dissatisfaction with military retirement. For example,

³The difference between the estimated \$7 billion increase in the unfunded liability and the estimated \$7.5 billion in reduced accrual payments under Redux is due to the fact that the DOD proposal represents only a partial repeal of Redux. As discussed, DOD's proposal does not call for totally repealing the reduced COLA.

the Army conducts a semi-annual personnel survey that addresses satisfaction with 56 aspects of military life, one of which is retirement "benefits." Since 1992, satisfaction with retirement benefits has declined steadily. However, the results may not be directly attributable to retirement pay because the survey lumps all retirement benefits together, including pay, health care, commissary privileges, access to recreation facilities, and others.

Another example is a late-1998 Air Force survey of 633 departing personnel. Retirement pay was cited as an important reason for separating from the Air Force by 58 percent of the enlisted respondents and 42 percent of the officers. Other reasons cited were the availability of civilian jobs, pay, frequent moves, and compatibility of the military with family life. Approximately 86 percent indicated that retirement was not a good incentive to serve 20 years or more. However, when asked if there was one single thing that the Air Force could do to keep them in the service, only 35 percent of enlisted personnel and 48 percent of officers said that there was. Of those who indicated that there was one single change that could be made, the most frequently cited changes were more choice in assignments and a decrease in the amount of time spent away from their home station. Retirement was not among the single changes that were cited as being sufficient to keep them in the service. Officers wanted more say/choice in assignments and a decrease in OPSTEMPO; Enlisted Personnel wanted more pay, more control over assignments and to decrease OPSTEMPO.

These and other survey results also reveal that many military members do not understand their retirement systems. The Army's fall 1996 Sample Survey of Military Personnel showed that, of those who planned to stay in the Army until retirement, more than one-half of the officer respondents and two-thirds of the enlisted respondents did not know which retirement plan they were under. Even with the recent publicity surrounding retirement issues, approximately 58 percent of the enlisted personnel responding to a Navy survey in late 1998 indicated that they did not know what retirement system they were under. Such lack of knowledge makes the basis for their dissatisfaction unclear.

Issues Warranting Further Analysis

Before proceeding with changes to the military retirement system, Congress may want to seek the answers to several questions: (1) What is the nature of the retention problem? Is it widespread or limited primarily to relatively small pockets? Is it a transitory problem or is it expected to continue for the foreseeable future? (2) What is the link between

retirement pay and retention? (3) Should other aspects of retirement or the military compensation system be addressed in a more comprehensive way? Only with further examination of these questions can Congress be confident that changing the retirement system will solve DOD's reported retention problems and be cost-effective. I do not have the answers to these questions today—but believe that they are important enough to warrant further analysis.

Extent of Retention Problems Not Yet Known

According to DOD officials, aggregate historical retention patterns are relatively stable, but recent downturns in retention are indicators of an impending problem. The Air Force and Navy have recently fallen short of their retention goals. Some of the most critical shortfalls are in the Air Force, where overall retention rates are below target and second-term retention rates are at 68 percent, below the target rate of 75 percent.

Retention problems have reportedly been severe in certain jobs, such as pilots and computer specialists, among others. We are now reviewing the retention of pilots and other specialties where retention has been problematic. The results are expected to be available this summer.

Some shortfalls may be a relatively short-run problem. For example, the shortfalls may be related to how the services approached reducing the size of the force in the early 1990s. To meet reduced personnel ceilings and yet maintain readiness, the services generally opted to reduce accessions rather than separate experienced personnel. Those lowered accessions during the drawdown may be contributing to shortfalls, as the pipeline now has fewer junior personnel. With fewer junior personnel in the pipeline, DOD needs to retain a higher percentage to fill its now relatively constant personnel slots. This task is made more difficult because of the low unemployment rate and strong economy.

Unclear Link Between Retention and Retirement

The empirical link between retirement and retention has not been convincingly drawn. When asked about the effect of Redux on retention, the Marine Corps was blunt, saying that it is "difficult to quantify the impact of the Redux retirement system" and that it cannot "definitively substantiate" direct impacts on retention. Army leadership has said that retirement is less effective as a retention tool than it used to be. The service chiefs are united in their belief that Redux is hurting retention. This appears to be based on a combination of anecdotal reports, survey data, and professional military judgment.

This lack of hard evidence concerns us and concerns some in Congress. In October 1998, two members of the Senate Armed Services Committee sent a letter to the Secretary of Defense asking for an analysis of the likely impact of DOD's pay and retirement proposals. During January 1999 testimony, the Chairman of the Joint Chiefs of Staff was asked about this analysis. He cited the concerns evidenced in the surveys and said that taking time to perform detailed studies might lead to the "demise of the force." Similarly, the House National Security Committee has twice requested that DOD report on the effects of Redux on retention, among other items. The first of these reports, requested in the House subcommittee report on the fiscal year 1998 Defense authorization act, was never received. The second report, requested in the House report on the fiscal year 1999 Defense authorization act, is due June 30, 1999.

Several factors blur the link between retention and retirement. It has not been shown that retention among personnel that entered the service under Redux is lower than it is for those that entered under the previous systems. Also, the decision to stay in or leave the military is complex and based on a number of factors. Finally, deferred compensation such as retirement pay is typically less of an incentive than up-front compensation for retaining personnel. I will expand on each of these points.

Historical data shows no conclusive evidence of a lower retention rate for Redux personnel. The Congressional Budget Office (CBO) analyzed retention decisions of personnel who entered the military around the time Redux was implemented. CBO has stated that its analysis generally shows no significant difference in retention under Redux. Had Redux been a major influence in the retention decision, fewer Redux personnel would be staying in the military.

The decision of whether to stay in or leave the military is complicated. DOD and the services contend that Redux is simply not attractive enough to keep people in like the previous systems did. In addition to retirement, several other factors—civilian employment opportunities, quality of life, and general satisfaction with military life ranging from military housing to rotation policies—influence retention. These influences are difficult to isolate.

Finally, increasing retirement pay may not be the most cost-effective way to increase retention. Rand believes that targeted pay increases—of the type that DOD is proposing—are the most effective way to address pockets of retention problems. Increasing retirement pay is generally seen as a less

effective incentive compared to increasing current pay because of the tendency of military personnel to deeply discount the value of future dollars. For example, personnel who were offered early separations during the drawdown showed a strong preference for the cash incentives rather than an annuity—even though the annuity was worth more from a present value perspective. According to an analysis performed by DOD, approximately 50 percent of officers and around 90 percent of enlisted people took the up-front payment, even though the present value of the annuity was, in many cases, worth more than twice as much. In addition, since retirement pay is computed on basic pay, an increase in pay also results in an increase in retirement pay.

Other Issues to Consider

DOD may be missing an opportunity to take a more comprehensive approach to its compensation system. The purpose of the military compensation system is to attract, retain, and motivate the number of quality personnel needed to maintain the desired level of national security. The military compensation system is a complex accretion of over 40 different pays and allowances, many of which came into being to address a specific problem at the time. Over the past 50 years, at least 15 presidentially or congressionally commissioned study groups have recommended improvements to the system. While the level of compensation has changed dramatically over that period, the features of the military compensation system have changed relatively little.

The most recent broad review of military compensation, the Eighth Quadrennial Review of Military Compensation, sought to design a compensation system that would attract, retain, and motivate the diverse workforce of the 21st century. Its June 1997 executive report encouraged a broad, strategic approach to human resource management systems through which DOD would align its personnel practices with the strategic direction of the organization. The report says that a comprehensive review of the compensation system requires the military to include everything that servicemembers value, and it concludes that “one size does not fit all.”

In 1996, GAO hosted a roundtable of military experts to discuss possible changes to the military retirement system.⁴ The consensus of the panel members was that the military retirement system—while exerting a strong pull toward retirement after members reach 10 to 12 years of service—can

⁴Military Retirement: Possible Changes Merit Further Evaluation (GAO/NSIAD-97-17, Nov. 15, 1996).

actually impede effective force management. Many of the participants indicated that the 20-year vesting provision of the retirement system is a hindrance to effectively managing the force. Because military personnel are not entitled to any retirement benefits unless they have served 20 years, the services have been reluctant to involuntarily separate personnel as they approached 20 years of service. And although some military combat specialties (like infantry) require youth and vigor, experience may be of greater value in occupations such as intelligence analysis or systems acquisition.

Once a member reaches 20 years, the previous retirement systems tend to exert a considerable "push" effect. As I noted earlier, about 47 percent of retirees leave within one year after reaching 20 years of service; by the end of 22 years of service, almost 70 percent have left. Part of the rationale for the Redux reform was to increase the size of the career force by reducing this push effect. If Redux is repealed, we will not know whether it would have achieved the objective of stemming the loss of senior career personnel—and repeal may have an unintended consequence of reducing the incentive for people to stay in the military after they become eligible for retirement.

In summary, I believe that changes to the military retirement system must be carefully analyzed. Such changes would apply across the board and would likely have a long-term effect. Overall, DOD has not demonstrated that the proposed change to the retirement system, estimated to cost \$13 billion in higher accrual payments to the retirement trust fund and an increase in Treasury's unfunded liabilities, is a cost-effective way to improve retention.

A number of questions should be explored before making changes to a system that has been changed only twice in over 50 years. First, we need to understand what kind of a retention problem exists. Are retention problems focused in certain subpopulations or do they apply across the force? Are current retention problems a transitory result of such factors as restricted accessions during the recent military downsizing and a good economy, or do they signal a long-term decline in the attractiveness of military careers? Second, we need to understand the relationship between the retirement system and retention, particularly its relative importance to servicemembers compared to other changes that might be made in compensation or quality of life in the military. Would spending scarce resources to increase retirement benefits have a greater impact on DOD's current and long-term manning than spending those resources in other

areas? Finally, given that the first retirees under Redux will not reach retirement eligibility until 2006, an opportunity exists to take a longer term, strategic perspective. Is the current military compensation system, which is the result of an historical accretion of elements, best suited for meeting our national defense manning needs into the 21st century?

Mr. Chairman, this concludes my prepared statement. We are prepared to respond to any questions that you or other Members of the Subcommittee may have.